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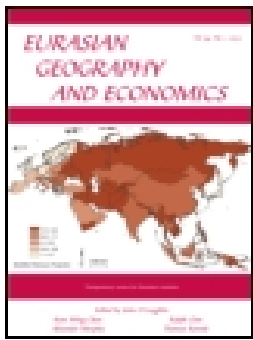
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## Managing the flows of gas and rules: Ukraine between the EU and Russia

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The article explores the impact of the EU and Russia on domestic change in the gas sector in Ukraine. It seeks to identify the barriers to, and triggers for, Ukraine's alignment with EU rules against the backdrop of Ukraine's energy dependence on Russia by focusing on the institutionalization of energy relations. By studying the whole post-Soviet period, this article provides a comprehensive overview of the interplay of domestic and external factors shaping the energy sector in Ukraine and illuminates the often paradoxical effects of external influences on domestic actors' preferences and strategies. We argue that EU influence was ineffective in overcoming domestic barriers to reforms and that it was Russia's coercive actions that have led to the adoption of EU rules by Ukraine, despite powerful domestic vested interests and the weaknesses in EU's policy.

**Keywords:** Ukraine; Russia; European Neighborhood Policy; energy; Energy Community; gas market; interdependence

### Introduction

The energy sectors in the countries in the post-Soviet states in Europe are characterized by simultaneous flows of energy resources and rules: Russia exports hydrocarbons whereas the European Union (EU) promotes regulatory frameworks. Russia's influence in the so-called 'near abroad' is greatly facilitated through asymmetric energy interdependence. In turn, while being energy-poor itself, the EU endeavors to export 'good governance' to the post-Soviet countries participating in the European Neighborhood Policy (ENP) and the Eastern Partnership (namely Azerbaijan, Armenia, Belarus, Georgia, Moldova, and Ukraine). Therefore, the post-Soviet countries located within Europe (hereafter 'the neighboring countries'; not including the three Baltic states, Estonia, Latvia, and Lithuania, which are EU members) are simultaneously subjected to the influence of both the EU and Russia.

These flows reflect diverse and mostly competing objectives of the EU and Russia. Russia's interest lies in perpetuating these countries' energy dependence on it, not only because of the revenues from exports but also because of the political leverage this provides over those countries. While promoting security of supplies, the EU promotes diversification, market principles, and energy efficiency, which would lower their dependence on Russia and thereby circumscribe the influence of Russia.

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The recipients are – with the exception of Azerbaijan – energy-poor. Moreover, their asymmetric energy interdependence with Russia is compounded by a pipeline network and location of refineries that is completely structured around supplies from Russia. However, the neighboring states have handled this legacy in very different ways, which is worthy of analysis for two reasons. First, energy has been a pivotal indicator of these countries' economic and political trajectory since the collapse of the USSR (Von Hirschhausen and Waelde 2001). Reforms in the energy sector (and the readiness to incur related political and economic costs) have been a strong indicator of the overall will and capacity to carry out domestic reforms writ large. Second, energy interdependence has had a profound effect on the foreign policies of the post-Soviet countries, both for energy exporters or importers.

Understanding developments in the energy sector requires an examination of both domestic and regional dynamics, and involves a plethora of domestic and international actors with a complex mix of motives. This internal–external nexus is particularly well illustrated in the case of Ukraine. Nominally, Ukraine's strategic interests in the energy sector coincide with those of the EU and are essentially focused on minimizing the negative political and economic consequences of being an energy-poor state (Razumkov Centre 2012, 35).<sup>1</sup> Yet, notwithstanding political declarations and legal obligations, the political elites failed to restructure the energy sector by adopting EU rules until 2014 (when dependency on Russia became securitized).

The ruling elites, which have been closely intertwined with the business interests of the so-called oligarchs, have had multi-layered and even contradictory preferences with regard to Russia and the EU. They have favored economic integration with the EU and have advocated a path to membership, with no political force openly opposing integration with the EU (Wolczuk 2008). At the same time, the Ukrainian elites repeatedly eschewed offers of closer economic integration with Russia, preferring instead to cooperate within the loose framework of the Commonwealth of Independent States (CIS), despite Ukraine's highly asymmetric interdependence with Russia and the latter's use of energy dependency to achieve its own political goals vis-à-vis Ukraine (Dragneva and Wolczuk 2015). Yet, curiously, Ukraine did little to wean itself off its gas dependence on Russia and did not reform the energy sector in order to reduce Russia's leverage over Ukraine.

This article seeks to explain this puzzle by examining the role of Russia and the EU in shaping the energy sector and the receptivity of the domestic actors in Ukraine to these external influences. It is argued that Ukrainian authorities failed to reform the energy sector in line with EU stipulations because the sector generated massive rents for the ruling elites. The elites acted as powerful gatekeepers, responding to external influences to maximize benefits and minimize constraints (Gnedina 2015; Tolstrup 2014). We explore and explain the mixed pattern of resistance and openness to the EU's export of rules against the backdrop of Ukraine's energy dependence on Russia. Up to now, these two vectors tended to be analyzed separately. These parallel investigations are hardly surprising, given the complex and very distinct nature of EU–Ukraine and Ukraine–Russia energy relations. Our aim is to bring the two strands of relations together and focus on the pattern of institutionalization and legalization of relations in order to identify the barriers and triggers for Ukraine's alignment with EU rules.

This article illuminates the often paradoxical effects of external actors on domestic change. The shifting patterns of influence can be broadly divided into three distinct periods. During 1991–2004, Russia was a dominant external actor, which provided powerful incentives for eschewing reforms – rents accruing from gas trade with Russia emerged

at the heart of the political system in Ukraine. At the time, the costs and risks of non-reforms and ‘addiction to cheap gas’ were not (yet) apparent. During this period the EU was weakly engaged with Ukraine. Between 2005 and 2013, however, the context changed dramatically – Russia steeply raised gas prices and explicitly linked their reduction to Ukraine’s participation in the Russia-led integration regimes. Having failed to reform the energy sector, Ukraine was increasingly vulnerable to the Russian issue linkage. This predicament prompted an unexpected turn to the EU to fend off Russian demands (Guzizullin and Lozovyy 2011). President Yanukovich made far-reaching commitments to integrate Ukraine into the EU energy market. Yet still the elites eschewed their domestic commitments. The third period – from 2014 onward – is marked by a radical cutting off of ties with Russia, with Ukraine finally starting to reform the energy sector. Our analysis indicates that, on its own, the EU’s influence was ineffective in overcoming domestic barriers to reforms, and it was Russia’s aggression that finally prompted Ukraine to align with EU rules.

In conceptual terms, in addition to Keohane and Nye’s framework (2000) as outlined in the Introduction to this Special Issue, the article relies on Hirschman’s work (1980) on the utilization of asymmetric economic relations as an instrument of national power. The Ukraine–Russia energy relationship can be explained by the ‘Hirschman effect’ which stipulates that, first, an asymmetric economic relationship between two states (such as Russia and Ukraine) has political consequences, and secondly, that economic relations influence the way in which governments define their interests, something which then impacts on foreign policy of the smaller state (1980). Asymmetric trade relations accrue political benefits to the larger state because it becomes a direct source of power over smaller states. Thus, as Abdelal and Kirshner (1999, 120) explain,

[I]f large country A trades with small country B, commerce between them might account for only two or three percent of country A’s exports and imports, but might well represent over half of country B’s. Such a relationship gives the larger country coercive power over the smaller, because an interruption of the relationship would cause much greater distress in B than in A. Threats of interruption, then, both explicit and implicit, give A power.

In essence, with asymmetric economic dependency it is the smaller country that carries the bulk of the cost of a breakup of such a relationship, while, conversely, powerful states can exploit economic dependence for their own political ends. Crucially, the Hirschman effect is not merely caused by asymmetries in economic relationships per se, but, in particular, by the ways in which this dependence impacts on smaller states’ preferences: one of the key factors of influence is ‘the strength of the vested interests which A has created by its trade economics of B’ (Hirschman 1980, 18). Thus, international economic relations affect domestic politics in smaller states primarily because incentives offered by the larger state shape the vested interests in the smaller state: ‘[T]he pattern of economic relations, especially during periods of political transition when national interests are most malleable, will have a formative influence on their trajectories’ (Abdelal and Kirshner 1999, 122).

We argue that the way that the Ukrainian elites managed their country’s asymmetric energy dependence on Russia not only perpetuated this dependence, but, more importantly, shaped Ukraine’s political and economic trajectories since independence. In 2014, Ukraine took drastic steps to reduce this dependence and resulting vulnerability but, after two decades of non-reforms, adopting EU’s regulatory framework will be a difficult and long-drawn process.

## Energy interdependence and the political economy of the energy sector (1992–2004)

### *Ukrainian–Russian energy interdependence*

Abundant energy resources underwrote the Soviet economic model and its highly distributive nature. Energy resources extracted in individual republics served the purpose of the economic development of the USSR without benefiting the energy-rich republics as such. Ukraine was largely self-sufficient in terms of natural gas in the 1950s, but within two decades its gas fields were (prematurely) depleted for the sake of all-Soviet development, leading the Ukrainian Soviet Socialist Republic (UkrSSR) to become dependent on gas supplies from Russia. At the same time, energy prices were not factored into production costs, something which favored the development of energy-intensive industries, such as metallurgy and chemicals, and nurtured a wasteful culture of gas use by households and industries. Across the USSR, including the UkrSSR, resource abundance resulted in the development of a highly inefficient, energy inefficient economic structure (Shabad 1969).

When the republican elites in Ukraine pushed for independence in 1991, little thought was given to the implications of being an energy-poor state burdened with highly energy-intensive economic structures. No strategy was developed to reduce Ukraine's energy inefficiency – among the world's highest. Ukraine simply relied on a continuous supply of cheap gas from Russia and continued to subsidize domestic consumers. Even with the low price of gas, at around US\$50 per thousand cubic meter (tcm), Ukraine struggled to pay for gas imports and rapidly accumulated a large debt to Russia, leading to energy becoming a continuous 'bone of contention' in bilateral relations. The Ukrainian leadership exploited Ukraine's status as a key transit country for Russian gas to the European market: 80 percent of Russian gas to the West traversed Ukraine. As Kyiv believed it unthinkable that Russia would jeopardize supplies to Western consumers to pressurize Ukraine, this transit status conferred some power to Ukraine and lowered the asymmetry of energy relations. However, this interdependence and reliance on Ukraine's importance to Russia only disinclined the Ukrainian elites to reform the sector which had fast become central to the political economy of energy rents (Balmaceda 2013).

### *Russia's policy toward Ukraine (1992–2004)*

In the 1990s, Russia's policy toward the 'near abroad,' including Ukraine, was rather inert. This stemmed at least partially from Russia's perceptions of Ukraine's separation from Russia as a temporary phenomenon (Lester 1994). Russia continued to subsidize oil and gas supplies to Ukraine in order 'to maintain the notion that their relations are not simply relations between any two states' (D'Anieri 2002, 45) and thereby preserve the 'privileged ties' between them. This also ensured that diversification of supplies was not an economically viable strategy for the newly independent states (Balmaceda 2013).

However, already at this stage, Russia was not averse to exploiting energy prices and debt to further its geopolitical preferences. For example, in the early 1990s Russia made gas prices and/or debt reduction contingent on Ukraine's compliance on the status of the Black Sea Fleet (BSF) in Crimea, which allowed Russia to retain military bases on Ukrainian territory (Wolczuk 2003). By capitalizing on Ukraine's geopolitical importance for Russia and making periodic strategic concessions, Ukrainian leaders

were able to procure low gas prices from Russia. Also, Ukraine's chronic inability to service its massive energy debt was largely overlooked (Newnham 2011, 138) or managed through various 'swap schemes' (Toritsyn and Miller 2002). Officially, the Kremlin kept gas prices frozen at about US\$50 per tcm till 2004, with much of the bill reduced *in lieu* of transit fees for gas being sent on to Western Europe. This murky pattern of gas purchases and transit fees allowed elites to extract considerable rents, something which reduced the incentives for domestic reforms, investment, and diversification of supplies.

Energy relations between Ukraine and Russia were highly politicized and not effectively institutionalized. Russia excluded energy from multilateral legal agreements, preferring ad hoc arrangements with the dependent states. Symptomatically, energy was excluded from the 1993 free trade area (FTA) bilateral agreement between Russia and Ukraine and the 1994 and 1999 CIS FTAs (neither of which were ratified by Russia, as it happens). Contracts were negotiated at the highest political level in an ad hoc and opaque way through secretive negotiations, which involved presidents, prime ministers, and officials from the state-owned companies Gazprom and Naftogaz (Balmaceda 2008). Only the broad contours of the agreements were made public, but it is clear that in legal terms, these contracts lacked precision in many important respects, such as mechanisms for dispute resolution, meaning that disagreements required new rounds of negotiations. Yet this very low degree of institutionalization and high degree of politicization were actually satisfactory to both Kyiv and Moscow. The fact that many legal and technical issues, such as the location of the metering stations, remained unregulated provided ample opportunities for diverse interpretations and exploitation both by Ukraine and Russia. With gas dependency elevated to the top of the political agenda between the two countries, gas price and energy debt were linked with other nominally unrelated issues, such as the BSF, border disputes, or Ukraine's participation in integration projects (see below).

### ***Ukraine's management of interdependence (1992–2004)***

The interdependence of Ukraine and Russia with regard to supplies and transit was a legacy of Soviet planning. High interdependence is deemed a key factor affecting the EU's rule transfer in the eastern neighborhood (Dimitrova and Dragneva 2009). Conversely, high dependence on other external actors is believed to constrain such a transfer. But we argue in the article that the explanatory power of dependence is actually limited. Most post-Soviet states were dependent on gas supplies from Russia, yet they adopted vastly different strategies to deal with their energy-poor status as exemplified by the diverse trajectories of the three Baltic republics and Ukraine in the energy sector. The key issue is not so much the asymmetric interdependence per se, but how it has been viewed and managed by the energy-poor states (Balmaceda 2013).

Ukraine's handling of its energy-poor status was perplexing. It failed to introduce energy efficiency and to diversify its supplies and contracts over two decades. Diversification is only possible by adopting longer time horizons and developing a long-term strategy backed by sufficient investment in infrastructure. And while Ukraine made some efforts to diversify supplies to import gas from Central Asia, this strategy was foiled by Russia's control over the pipelines that delivered Central Asian exports to the West (Balmaceda 2008). Yet at the same time, Ukraine behaved like an energy-rich state and kept prices low for domestic consumers – low gas prices were one of the few public goods that the elites were able to deliver, albeit nominally (see below). This merely



entrenched a culture of energy waste and discouraged investment in the energy sector, including the pursuit of energy efficiency and the extraction of remaining domestic gas reserves (for example, in the Carpathian mountains) and exploration of new ones (in the Black Sea). The low prices created various anomalies and failings affecting society at large; for example, state subsidies for municipal heating facilities were very high and there was little investment in the district heating infrastructure, leading to increasingly frequent outages at the local level (Mayhew 2010). The costs of artificially low prices (for non-industrial consumers) and the high rate of non-payment (by both residential and industrial users) were borne by society at large (Balmaceda 2013). Because of low prices, the Ukrainian gas company, Naftogaz, was unable to recover the cost of imported gas and the company's debt was shifted to the Ukrainian budget, significantly weakening the condition of public finances.

Yet low gas prices were critical for Ukraine's economy, helping it survive the recession of the 1990s (Mayhew 2010) and then to grow in the next decade, thanks to international demand for products from its key energy-intensive industries: metallurgy and chemicals. These two industrial sectors came to dominate Ukrainian exports in the 2000s (Sleptsova 2010), turning Ukraine into the largest consumer of Russian gas in the world between 2000 and 2006 (see Końonczuk 2015).

#### *Political economy of the energy sector*

Von Hirschhausen and Waelde (2001) argue that the energy sector either accelerated or hindered change in post-communist countries depending on the degree of its politicization. Indeed, one of the key common features of the countries in the 'common neighborhood' has been the reliance of their political regimes on rents from the energy sector both in the energy-rich and energy-poor states. This is only too evident in Ukraine, where oligarchs' wealth originated in the energy sector in the 1990s (see Balmaceda 2013) and they ended up controlling nearly half of the Ukrainian economy, including chemical and metallurgical enterprises as well as the regional energy distribution companies. In turn, this wealth allowed the oligarchs to tighten their grip on the state institutions and policies related to the energy sector.

State policy resulted in a monopolized system both with regard to imports and domestic structures: Naftogaz of Ukraine was in fact created as a vertically integrated oil and gas company engaged in the full cycle of operations in gas and oil field exploration and development, production and exploratory drilling, gas and oil transport and storage, and supply of natural gas and LPG to consumers. Naftogaz, which itself is the state-owned joint stock company subordinated to the Ministry of Fuel and Energy of Ukraine, has been the sole owner of the natural gas transmission system operator, the public joint stock company Ukrtransgaz (ECS Report 2014).

*De facto*, Naftogaz developed into a fronting institution controlled by and benefiting the governing elites – it was set up to socialize the costs of energy and the privatization of the rents.<sup>2</sup> The benefits accruing from the energy sector were enjoyed by a narrow group of decision-makers within the executive branch, the Presidential Administration and the Cabinet of Ministers, with no public scrutiny and accountability.

Owing to their high energy intensity, Ukrainian industries depended on low gas prices to remain competitive – low prices came to be defined as a vital national interest of Ukraine. In many respects, keeping energy prices at a low level became a *reform-substitution* strategy in Ukraine, while the energy sector as a whole played a pivotal part in creating and sustaining the political system in post-Soviet Ukraine, which was



centered on state capture and rents (Balmaceda 2013). In this respect, the energy dependence with Russia had a formative impact on the trajectory of post-Soviet Ukraine because it shaped the very notion of national interest and the domestic structures and policies.

### *Ukraine–EU relations and the energy sector reforms (1992–2004)*

The system of (mis)management of energy interdependence had become entrenched between 1992 and 2004. During this period, the EU was weakly engaged with Ukraine in general and in reform of the energy sector in particular. The key bilateral document governing cooperation between the EU and Ukraine in the energy sector was the Partnership and Cooperation Agreement (PCA), which was in force between 1998 and 2014. It provided the general framework of EU–Ukraine energy cooperation but did not include any specific commitments and schedule for their implementation. It merely referred to the European Energy Charter of 1991 as the framework for cooperation of the EU with third countries. One of the EU's forms of engagement was via the INOGATE program, launched in late 1990s to promote regional integration of pipeline systems and to facilitate oil and gas transport within the post-Soviet states and onwards to EU markets. Over the years, INOGATE's scope was extended to include electricity, renewable energy, and energy efficiency and to encourage private investment and support from international financial institutions.

Nevertheless, interactions with the EU on energy-related issues through the PCA institutional framework and INOGATE provided important insights into best practice in the EU and its growing body of regulations. This knowledge generated strong demand for reforms among state officials, experts, and civil society (see Razumkov Centre 2001, 2012) as a means of 'cleansing' and modernizing the sector. Already in 2001 it was recognized that

Adaptation of Ukraine's energy legislation to the norms and standards of the EU is intended to: limit administrative interference of the state into the fuel and energy complex; liberalise energy markets; create a favourable investment climate for attraction of foreign capital into the fuel and energy complexes; raise energy efficiency of the economy; employ energy conservation potential; enhance nuclear safety; reduce negative environmental effects of the fuel and energy complex; create strategic reserves of oil; and so on .... (2001, 58)

However, as the EU policy frameworks lacked powerful incentives and binding commitments, they were unable to override elites' vested interests within the energy sector. While making pro-European declarations, the political elites in Ukraine acted as powerful gatekeepers, resisting influences that would jeopardize their particular political and economic interests.

In 2003–2004, the EU launched its flagship policy for the southern and eastern neighbors – the ENP. At first, the ENP hardly increased the EU's influence, not least because the EU even refrained from advocating specific regulatory templates in the early stages of the policy. The key instruments were Action Plans, which subsequently were re-named the Association Agendas. The 2005 Action Plan for Ukraine provided only a vague and sketchy outline of expected alignment (Magen 2007; Wolczuk 2009).

Overall, the EU did not shape developments in the energy sector in Ukraine during 1992–2004 in any meaningful and tangible way. Clearly, by the time the EU started to engage more closely with Ukraine in the mid-2000s, it came at a much later stage of the post-communist transformation than in East-Central Europe. This time lag meant

that the vested interests were well consolidated, and corruption in the energy sector came to underpin the whole post-Soviet political regime in Ukraine. Nevertheless, through network governance and socialization, already at this stage the EU became recognized as the key source of reform templates among reform-oriented domestic actors. The EU's role grew further in prominence as Ukraine's relations with Russia became strained during 2005–2013.

### **Ukraine's multi-vector energy policy (2005–2013)**

From 2005, energy prices began to rise and the contradictions within Ukraine's energy policy became more profound and exposed, as Russia sought to capitalize on the leverage that rising energy prices provided. The most glaring of these contradictions was Ukraine's explicit, far-reaching commitment to adopt EU rules to fence off Russian demands, while failing to implement the necessary domestic reform, as will now be explored.

### ***Problems and tensions in Ukraine–Russia energy relations***

#### *Russia's 'petro-power' and Ukraine*

When Russian President Vladimir Putin came to power in 2000, energy prices were on the rise. Mindful of the loss to the Russian economy from selling gas to former Soviet republics at very low prices, Russia started to price its exports to the post-Soviet countries at the European netback level (that is, equal to the price of Russian gas in Europe, minus the additional transit cost). However, while important, money was not the only motive: in practice, Russia's policy remained guided by a complex mix of commercial, geopolitical, and political motives, meaning that the implementation of this formula varied greatly across the post-Soviet space. While Russia raised the prices for all post-Soviet states, it demanded higher prices and faster rises for the states pursuing – what was perceived in Moscow – as unfriendly policy (Newnham 2011, 139).

Ukraine was among such states. The Orange Revolution in Ukraine in 2004 triggered fear in Russia of 'democratic contagion' to other republics, exacerbated by the pro-western orientation of Ukraine's new president, Viktor Yushchenko. In response, in 2005 Russia attempted to increase prices nearly fivefold – from US\$50/thousand cubic meters (tcm) to US\$235/tcm in 2005 (Pirani 2012, 176). Furthermore, Gazprom suddenly demanded full payment of Ukraine's accumulated debt for gas supplies, which Ukraine was simply unable to pay. This led to the first 'gas war' in January 2006, when Ukraine refused to agree to the price rise and Russia halted gas supplies to Ukraine, which in turn limited supplies to countries in Europe. This shattered the long-held belief in Ukraine that Russia would never sacrifice delivery to West European customers in order to punish Ukraine. The first 'gas war' ended with an agreement on US\$100/tcm. Yet, as an illustration of the clandestine nature of negotiations, intermediate companies were brought in to broker the deal, such as RosUkrEnergo, controlled by Gazprom and the Ukrainian oligarch, Dmytro Firtash, which resulted in significant rent extraction and what Balmaceda (2013, 21) calls 'transborder sharing of rents' with Russian elites. While the prices started to rise, this deal dissuaded the Ukrainian ruling elites from diversifying the supplies.

Gas supplies to Ukraine were subject to annual negotiations until 2009 when a second gas war erupted owing to an inability to agree on terms. This longer crisis, which caused considerable disruption of supply to Europe, resulted in new, worse terms for Ukraine. The government of Ukrainian Prime Minister Yulia Tymoshenko demanded the removal of the intermediary company. Yet, because the pricing formula linked gas prices to oil prices, Ukraine ended up paying higher prices than many EU member states (Matuszak 2011). The terms of the 2009 agreement reflected Ukraine's weakened bargaining power vis-à-vis Russia. The gas price became highly politicized domestically: the highly unfavorable gas agreement was used by the Yanukovich regime in the trial and subsequent imprisonment of Yulia Tymoshenko in 2011.

Crucially, Russia sought to strengthen its position by reducing its reliance on Ukraine as a key transit route to Europe. Despite a weak economic rationale, Moscow sought alternative routes, including Nord Stream and the (now defunct) South Stream pipelines, the combined capacity of which would exceed the Ukrainian Gas Transportation System (GTS)'s capacity. Russia's leverage increased, making Ukraine even more vulnerable.

In 2010, Russia agreed to a discount to secure a prolongation of the BSF base lease in Crimea (see below). Furthermore, Russia offered to lower prices (from US\$425 to US\$168/tcm) if Ukraine were to accede to the newly formed Eurasian Customs Union, as well as cede control over the GTS to Gazprom (Dragneva and Wolczuk 2015). Yanukovich refused the offer, as the GTS was one of the very few 'aces up his sleeve,' whereas Russia's offer fell below Ukraine's valuation.

Overall, in contrast to the EU, Russia favored a low degree of institutionalization; it did not seek to introduce a codified corpus of rules nor seek to institutionalize negotiations beyond the use of the intermediate trading companies, as stipulated in the 2006 contract (see earlier). This was despite the fact that Ukraine could hardly be regarded as a reliable partner and was unable to service its chronic energy debt. There are at least three reasons why the opaque, corrupt, and uncompetitive gas sector in Ukraine served Russian interests. First, the (mis)management of the gas sector maintained Ukraine's 'addiction to Russian gas'; until 2013, Ukraine remained one of the largest importers of Russia gas in the world. Secondly, this asymmetric interdependence offered Russia opportunities to achieve broader geopolitical goals vis-à-vis Ukraine via issue linkage. Third, gas trade with Ukraine provided opportunities for gas deals that generated rents for the Russian elites, something which Russia's gas exports to EU member states – based on commercial principles – did not provide on the same scale.

*Ukraine's management of interdependence with Russia (2005–2013).* Because of the all-pervasive corruption in Ukraine, the promise to eliminate it, which was made during the Orange Revolution, accounted for a significant appeal of the new leadership. However, the new Orange elites lacked a broader strategy to deal with gas interdependence and prevailing inefficiencies at the very time when global energy prices were rising. Instead, Tymoshenko fought to attenuate the influence of Dmytro Firtash, who benefitted handsomely from the 2006 energy deal and enjoyed the backing of President Yushchenko. The new leadership simply perpetuated the corrupt system of rents (Greene 2012) as energy rents continued to underpin the political system during Yushchenko's Presidency. But while there was significant resistance to economic reforms (Åslund 2009), gas prices went up dramatically; the cost for Ukraine increased almost eightfold, namely from US\$50 in 2005 to US\$425 in 2012. This became a formidable burden on the Ukrainian economy and state budget, with Naftogaz debt to Gazprom accounting for

6–7 percent of the state budget in 2013 (Pirani 2014). Yet, despite the public finance crisis, the Ukrainian elites were unwilling to raise domestic prices for gas, even though this led to the failure of Ukraine to secure IMF financial assistance in 2011 and 2013.

The longstanding pattern of (mis)management in the energy sector intensified with the coming to power of Viktor Yanukovich in 2010. According to Åslund (2014), President Yanukovich extracted rents of approximately US\$3 billion per year. Retaining low energy prices for the population stemmed not only from the need for electoral support, but it also left plenty of room for manipulation of the system so that it benefited the ruling elites. Against the backdrop of the 2008–2009 economic crisis, during which Ukraine's GDP shrunk by 15 percent in 2009, a gas price reduction was regarded as pivotal to Ukraine's economic recovery.

With the political regime and Ukraine's overall economic performance dependent on access to cheap energy resources, lowering the price of gas was the top priority for the Yanukovich regime within which oligarchs played a prominent role (see Gnedina and Sleptsova 2012). In pursuit of lower prices, Yanukovich sought to capitalize on Ukraine's geopolitical importance for Russia by making strategic concessions. He signed the 'Kharkiv Accords' in April 2010, which extended the lease of the Sevastopol naval base to the Russian Black Sea Fleet for 25 years (until 2042) for a 30 percent discount in relation to the pricing formula agreed to in the 2009 contract. Symptomatically, once again, as with previous bilateral state agreements, the 'Kharkiv Accords' provided an unstable and contested legal framework lacking a reliable and transparent dispute resolution mechanism. Despite the 'political discount,' Ukraine still ended up paying more for its imports than some EU countries, notwithstanding the lower transit costs (Pirani 2014). Russia linked further reductions to yet more geopolitical and economic concessions, such as the 'merger' of Gazprom and Naftogaz, ceding control over the GTS and joining the Eurasian Customs Union (Sherr 2010; Dragneva and Wolczuk 2015). This issue linkage was ubiquitous in Russia's policy in the 'common neighborhood': Russia had been successful in obtaining similar concessions in Belarus and Armenia (see Ademmer 2015; Fear 2013): both of them ceded control over GTS and joined the Russia-led Eurasian project.

In the Ukrainian case, however, Russian pressure started to have the opposite effect. First, Ukraine's resolve to retain the GTS stiffened, despite growing economic and financial difficulties faced by the Yanukovich regime. Second, Ukraine started buying some gas on the spot market in Europe. Third, oligarchs began investing in energy efficiency in their businesses (Matuszak 2012). Fourth, despite a concerted campaign, the Ukrainian President refused to join the Eurasian regime (Dragneva and Wolczuk 2015).

Overall, during 2005–2013 Ukrainian governing elites pursued a policy that was bound to fail sooner or later: they sought low gas prices from Russia while resisting Russia's demands for ceding control over strategic assets and proposals for economic re-integration. During this very period, Russia launched its new integration project, the Eurasian Customs Union (2010), which evolved into the Eurasian Economic Union by 2015, and Russia sought to secure Ukraine's membership (Dragneva and Wolczuk 2013). Ukraine's resistance was motivated by concerns over an even deeper dependence on Russia leading to a loss of Ukraine's sovereignty but also a fear of a loss of rents accruing from the control of the GTS. Unwilling to meet Russian demands and/or embark on radical reforms of the energy sector, Ukrainian elites turned to the EU.

### ***The EU to the rescue? Ukraine–EU relations during 2005–2013***

During 2005–2013, Ukraine's engagement with the EU increased dramatically, although this was limited to rule selection (the signing of various agreements) and selective and incomplete rule adoption (the passing of laws), all of which amounted to a minimal, token compliance with EU reform guidance.

#### *EU's export of the energy-related acquis*

The EU is arguably the most extensively legalized international organization ever. Adhering to the 'regulatory state' model, it relies on regulations rather than re-distribution and direct intervention in industry (Goldthau and Sitter 2014). The creation of the single market for energy in the EU consisted of three main waves of legislation; the so-called energy packages, aimed at liberalizing energy trade in the EU member states and between them. A 1998 directive liberalized EU gas markets by promoting limited and gradual market opening, including, for example, derogations over take-or-pay contracts. The so-called Second Package of 2003 required that member states create an independent regulatory body, regulate access tariffs, and provide non-discriminatory third-party access through legal separation ('unbundling') of distribution from supplies. The Third Package of 2009 focused on ownership unbundling, new regimes for independent systems/transmissions operators, and stronger national regulators.

Notwithstanding the extensive regulations, energy market heterogeneity has persisted and indeed seems to be allowed under the Lisbon Treaty (Goldthau and Sitter 2014). This has not deterred EU institutions from exporting the energy 'rulebook' (*acquis communautaire*) beyond its borders on the European continent.<sup>3</sup> The energy component of the ENP and the Eastern Partnership, which was launched in 2009, exported rules as a way to promote good governance to both energy-rich and energy-poor countries in its eastern neighborhood, despite their divergent aspirations and prospects vis-à-vis the EU. Ukraine was one of those countries interested in closer integration up to and including membership (Wolczuk 2008).

With Ukraine, the first important initiative was the bilateral Memorandum of Understanding on cooperation in the field of energy (Memorandum of Understanding 2005), which stipulated the ambition to upgrade cooperation in the field of energy, aiming at integration of Ukraine into the EU's internal energy market. In the Memorandum, Ukraine declared its readiness to implement key elements of the EU's *acquis* on energy, environment, competition, and renewable energy sources and agreed to join the newly created Energy Community (see below). However, the Memorandum was a political pledge rather than a binding legal framework and lacked tangible economic incentives. As such, the Memorandum had little impact on domestic policy during Yushchenko's presidency (2005–2009).

The next significant step was taken in 2009 when a Joint Declaration was adopted at the Joint EU–Ukraine International Investment Conference on the Modernization of Ukraine's Gas Transit System, held in Brussels in March 2009. This was a joint initiative of Ukraine, the EU, the World Bank, the European Bank of Reconstruction and Development (EBRD), and the European Investment Bank (EIB) to assist Ukraine in modernizing the GTS with agreed funding up to €2,650,000 Joint Declaration 2009). Then the EU and Ukraine completed the 'Preparatory studies for modernization of Ukraine's gas transit and storage' in February 2011; that is, after Yanukovych's accession to power (Duleba, Benč, and Bilčík 2012).<sup>4</sup> Release of funding was, however,

made conditional upon Ukraine's progress in creating a domestic gas market in line with EU requirements.

The conclusion of these steps seemingly indicated Ukraine's readiness to adopt EU rules. However, like the PCA and the ENP Action Plan, these documents were political declarations – they lacked precision and a clear list of obligations, and with regard to energy, contained just a list of pledges that were not legally binding or enforceable. Also, the available incentives were weak, particularly compared to the high rents that the elites could extract from the energy sector, as explained above.

Nevertheless, despite weak incentives, the Ukrainian elites proceeded to commit to take on EU rules. The most significant and extensive legal commitment resulted from Ukraine's accession to the treaty establishing the Energy Community, which was ratified by Ukraine in 2010.<sup>5</sup> Ukraine became a member in 2011, and this membership continues to define Ukraine's obligations vis-à-vis the EU up to now.<sup>6</sup>

By joining the Energy Community Ukraine took on formal, extensive, and precise legal commitments to align with the EU energy *acquis*. The accession protocol included the energy *acquis* of the EU, which Ukraine has been obliged to harmonize with, as well as the timeline for its implementation. In comparison to the ENP, the Energy Community represented a fundamental shift from low precision/high selectivity to high precision/low selectivity commitments in Ukraine's relations with the EU. Ukraine nominally committed itself to joining the single energy market, the pre-condition for which was a fundamental reform of the energy sector. And yet, as will be discussed later, in practice only very limited progress was made in terms of domestic reforms during 2010–2013.

Why did Ukraine take on extensive legal commitments vis-à-vis the EU without enacting the necessary reforms? This puzzle is explained by Ukrainian leadership seeking to preserve Ukraine's near-monopolistic position as a transit country for Russian gas and using EU-related legal commitments to counteract the pressure emanating from Russia. They saw membership of the Energy Community as a means of securing the EU's support for Ukraine's key transit role while at the same time preventing Russia from taking over the GTS. Such a takeover would be in breach of the Third Package, which restricted access to the market and investment in the EU energy infrastructure for energy monopolies that fail to separate energy production, transmission, and supply. Membership in the Energy Community was a legal mechanism to weaken Russian leverage, something which had taken on a renewed impetus when Russia proposed 'enhanced cooperation in the energy sector' in the spring of 2010 (Sherr 2010). There were reasons for Ukraine to worry about the growing asymmetry; Russia was increasingly active in developing transit routes beyond Ukraine, as evidenced by the launch of the Nord Stream and the plans for the South Stream.

Ukraine's hopes of benefiting from membership in the Energy Community were dashed on two accounts. First, the EU did not object to the proposed merger of Gazprom and Naftogaz in the spring of 2010 and regarded it as a commercial deal, despite obvious consequences for the strengthening of Gazprom's monopolistic position in Ukraine with regard to supplies and transportation, thereby contradicting the provisions of the Third Energy package. After the Russian leadership tabled their proposals for the acquisition of Naftogaz, the EU Energy Commissioner stated that a takeover of Ukraine's GTS would be a purely bilateral matter between Ukraine and Russia – even though it would contradict EU's policy toward Ukraine, as it would spell the end of the adoption of EU rules on the gas market, including unbundling (Shapovalova 2010). Although EU rules prevented Gazprom from strengthening its position on the EU energy market through monopolistic arrangements, the EU had no corresponding qualms



in relation to Gazprom strengthening its position in Ukraine and other countries, such as Moldova.<sup>7</sup>

Second, the EU's endorsement of the construction of the Nord Stream pipeline bypassing Ukraine and the prospects of building South Stream indicated a lack of coherent strategy in the EU vis-à-vis Russia and Ukraine. The EU and the Energy Community were even reluctant to openly acknowledge, let alone counteract, the influence of Russia in the neighboring countries dependent on Russian gas imports. This was evident in countries where Gazprom exerted powerful leverage by acquiring controlling stakes in the national gas transit systems, such as Armenia and Moldova (Hunter, Lussac, and Wolczuk 2012).

Overall, the Energy Community was designed to promote transfer of the EU energy *acquis* to non-member states in Europe; it was not about shaping broader EU energy policy *vis-a-vis* the neighboring states. This resulted in 'unrealistic expectations,' in the words of the Director General of the Energy Community (ECS Report 2014).<sup>8</sup> In an asymmetrical relationship, the neighboring countries agreed to adopt EU rules, but could not rely on support from the EU institutions and member states when dealing with their specific energy predicaments.

#### *Ukraine's alignment with EU's gas market acquis (2010–2013)*

Ukraine's interest in using the EU to counterbalance Russia was evident in the limited degree of domestic reforms. Ukraine made legal changes in order to join the Energy Community. In particular, the law 'On the Principles of the Functioning of Natural Gas Market' passed in July 2010 provided for gas market reform in line with the Second Package of the EU. However, this was a very incomplete measure because the law did not supersede previous Ukrainian legislative acts (such as the Law on Oil and Gas, the Law on Pipeline Transport, the Gas Metering Law, the Law on State Regulation in Energy, the Law on Natural Monopolies, and the Law on Licensing Economic Activities) and was contradicted by them. These laws often regulated the same issues and impeded effective regulation (ECS Report 2014); moreover, no relevant secondary legal acts were adopted.

Ukraine committed itself to implement the Second Package by 2012 and the Third Package by 2015. After accession, Ukrainian authorities announced the restructuring of Naftogaz in order to improve competition in the gas market and to meet the requirements of the Third Package of the EU. Yet in practice, only measures which coincided with oligarchic preferences were adopted. This became apparent in April 2012, when the Ukrainian parliament amended the law on pipeline transport, authorizing the government to reorganize Naftogaz (Duleba, Benč, and Bilčík 2012). Under the bill, the Ukrainian Government could restructure Naftogaz by merger, acquisition, demerger, spin-off, or transfer. Nominally this law was adopted to fulfill Ukraine's obligations related to membership in the Energy Community, but in practice it was to facilitate oligarchic takeover of sections of the state monopoly. Naftogaz consisted of a number of sub-companies, dealing with production, distribution, infrastructure, and so forth, which were of interest to various oligarchic groups, but the actual restructuring of Naftogaz to implement the unbundling principle was not undertaken by the Ukrainian authorities.

The energy *acquis* also prescribes the creation of an independent regulatory authority by the member states of the Energy Community. Formally, Ukraine took some steps toward establishing an independent regulatory authority in November 2011, when President Yanukovich issued a decree creating the National Commission on the Energy



Regulation of Ukraine (NERC), which became the single authority for regulating the gas and electricity sector. However, this decree was not fully implemented. The NERC remained dependent on government decisions on the tariff regulation of energy markets and, hence, did not meet the requirements of the EU *acquis* (Duleba, Benč, and Bilčík 2012; Razumkov Centre 2012, 35). The NERC's competences remained limited, and it lacked a full range of regulatory powers foreseen under the Third Package, such as the right to carry out investigations, impose measures to promote competition and proper market functioning, and issue penalties to gas and electricity undertakings that did not comply with their obligations (ECS Report 2014).

The supply-driven nature of the EU's strategy accounts for its failure to factor in the political and economic context of individual countries. The Energy Community's depoliticized, legalistic, and technocratic approach failed to take into account the highly political nature of energy regimes in neighboring countries. Nominally technocratic solutions advocated by the EU are highly consequential in distributive terms – adoption of EU regulations on energy markets goes to the heart of the functioning of the political regimes in the post-Soviet countries in the 'common neighborhood.' Therefore, the Energy Community had little impact on domestic priorities and decision-making in Ukraine.

The Ukrainian Government failed to establish an independent energy regulatory authority, which was the key provision for the gradual liberalization of the gas market, including the unbundling of the energy monopolies (DIXI Group 2014). The lack of these reforms, in turn, meant that the EU was unable to release necessary funding for the much-needed modernization of the GTS. As a consequence, Ukraine's position as a transit country was further weakened.

### ***The end of 'the Balancing Act' between Russia and the EU***

Overall, between 2005 and 2013, Ukraine's management of its energy interdependence was contradictory. As far as Russia was concerned, Ukraine demanded low gas prices but resisted Russian plans for re-integration within the Eurasian project or ceding control of its strategic assets. With regard to the EU, Ukraine wanted to benefit from its support, but failed to enact the reforms that would facilitate this support. Both in relation to Russia and the EU, Ukraine sought to derive benefits without making reciprocal commitments. For the incumbent elites, integration with the EU was meant to enhance Ukraine's energy security in relation to Russia, especially through the discontinuation of the South Stream project and eliminating the possibility that Russia would gain control over Ukraine's energy infrastructure. Quite simply, the governing elites hoped to achieve these benefits without dismantling the well-entrenched domestic 'structures operating under the guise of state interests' (Razumkov Centre 2012, 33). It was noted that,

[T]he weaker Ukraine internally, the stronger the Russian factor – in internal affairs as well as international relations. For this reason, internal incapacity and external dependence have operated like the blades of a scissor, opening or closing in tandem. (Sherr 2006, 11)

This became only too evident in 2013, when Ukraine was sliding into recession and high gas prices crippled its unstructured economy.

In Hirschman's (1980, 27) words, 'harassed statesmen generally have a short-run view.' With Ukraine on the brink of recession, the political survival of the incumbent elites in Ukraine made them put a premium on a deal with Russia to secure a financial

bailout and to lower the energy price. The strategic concession that Ukraine offered on this occasion was suspending signing of the Association Agreement with the EU, which had been ready for signing since late 2011 (though the EU refused to sign it because of concerns over selective justice in Ukraine, namely the imprisonment of Yulia Tymoshenko). The ad hoc, secretive deal between Putin and Yanukovich in November 2013 was to bolster the latter's standing in preparation for the presidential elections of 2015, despite his dismal track record and low public support. In exchange for suspending the signing of the Association Agreement, Yanukovich obtained from Russia a \$US15 billion financial loan and a gas price lowered to US\$268/tcm, albeit temporarily (to be reviewed quarterly). Officially, Yanukovich did not agree to join the Eurasian bloc nor, more specifically, to suspend membership in the Energy Community. However, the decision amounted to a major integration U-turn by the Ukrainian leadership, which would further erode the already limited influence of the EU (Dragneva and Wolczuk 2015).

### **Ukraine since 2014: away from Russia, toward the EU?**

As is well known, the decision to postpone the signing of the Association Agreement triggered mass protests in Ukraine, culminating in the ousting of President Yanukovich in early 2014 and the formation of a new government in Ukraine followed by presidential and parliamentary elections in 2014. Having realized that economic and energy dependence was not enough to influence Ukraine's domestic and foreign policy, Russia shifted to coercive measures. Following the annexation of Crimea, Russia engaged in hybrid warfare in Eastern Ukraine (Freedman 2014). In parallel with violating Ukraine's territorial integrity, Russia has applied a number of trade restrictions, resulting in a threefold decline of Ukraine's exports to Russia. From January 2016, Russia unilaterally excluded Ukraine from the 2011 CIS FTA, something which, inevitably, further reduces Ukraine's trade with Russia, forcing a radical re-orientation toward the EU and third markets.

Energy has been a 'third front line' between Ukraine and Russia. The new Ukrainian Government, mindful of the unsatisfactory 2009 gas contract, objected to the pricing formula and sought to renegotiate the 2009 gas contract. Not only did Russia refuse – it actually canceled the discount that Ukraine had received in 2010 as a result of the 'Kharkiv Accords' on the basis that Crimea's 'reunification' with Russia meant that Moscow was no longer required to pay for the lease for the military base for the stationing of the BSF. As negotiations on gas prices broke down, Russia halted gas supplies in June 2014, and Ukraine relied on limited domestic extraction and reverse flows of cheaper Russian gas from Poland, Hungary, and Slovakia. Thanks to EU mediation, a short-term compromise was worked out and the so-called 'winter and summer packages' agreed in the autumn of 2014 and in the spring of 2015. Nevertheless, once again, in the summer of 2015, Ukraine and Russia failed to agree on a new gas price on the basis of the disputed 2009 contract. Russia suspended supplies to Ukraine in June 2015, while both Gazprom and Naftgaz engaged in litigation against each other. For the first time in its post-Soviet history, Ukraine did not import any gas from Russia and, as Prime Minister Yatseniuk proudly stated, 'survived the winter of 2015–2016 without a cubic meter of Russian gas' (BBC Ukraina 2016).

Upon coming to power in 2014, the new authorities came to regard Ukraine's dependence on Russian energy as a major strategic threat and sought to rapidly diversify its supplies. Ukraine was able to source gas from Poland, Hungary, and Slovakia (in the case of the latter by a new inter-connector pipeline opened in the spring 2015). New

gas contracts with European gas companies have been transparent, vastly reducing the scope of rent-extraction in comparison to the pre-2014 period. In total, Ukraine almost halved its gas imports from Russia to a record low of 14.5 billion cubic meters of gas in 2014 (Varfolomeyev 2015), something which also reflected the decline in energy consumption stemming from a profound economic crisis in Ukraine. At the same time, considerable international assistance has been focussed on promoting energy efficiency. Thus, what post-Soviet Ukraine had not achieved after 20 years of existence, became possible within 18 months. Nevertheless, in the short- to medium-term, Ukraine will have to rely on some energy imports from Russia, but, given the considerable potential for energy savings and reverse flows of Russian gas from the EU, Ukraine's overwhelming dependence on Russian energy has declined dramatically, together with the influence that this rendered.

The conflict with Russia made Ukraine more dependent on support from the EU, resulting in the acceleration of the adoption of EU rules. In May 2015, the Ukrainian parliament passed a 'Law on the Gas Market,' one of the most significant reform measures adopted by the new government and a key precondition of IMF financial assistance to Ukraine. The law, which was drafted in cooperation with the Secretariat of the Energy Community, came into force in October 2015 and provides for full alignment with the Third Package, creating a basis for a competitive gas market in Ukraine. The new law deprives Naftogaz of its monopolistic status and forces a break-up of the company but also strikes at the interest of one of the most powerful oligarchs in Ukraine, Dmytro Firtash, who controls 80 percent of regional gas distribution companies in Ukraine. Despite being under indictment (2014–2015) and remaining in exile (as of early 2016), Firtash has retained his *de facto* monopolistic position with regard to gas market in Ukraine and has used his political influence to derail the reforms of the gas sector in Ukraine, when they threaten his position and interests.

The law relies on a number of other detailed legal measures and executive decisions. One of them relates to the creation of the independent energy regulator. The NERC, which never assumed such a role, is to be replaced by a new body, the National Committee on State Regulation of Energy and Utilities (NKREP), with a much broader scope of competences in line with the EU's Directive 2009/72/EC (Kończuk 2015). Further laws have been passed promoting enforcement and transparency in the gas sector. Crucially, the price for households and public sector consumers has been raised and is to increase by 300 percent by 2017.

Given the centrality of the gas sector for the political system, its reform is at the heart of domestic reform in Ukraine. However, rapid implementation of gas market reforms is unlikely. The 2015 Law is just a first of a series of long and challenging reform measures. The regulatory templates promoted by the EU do not lend themselves to fast and easy implementation. This is because the EU's approach has been supply-driven in the sense that it exports regulatory templates already developed within the EU; it is not a problem-solving measure for a crisis-stricken country with limited capacity and resources, on the one hand, and, powerful vested interests, on the other. As Magen (2007, 366) noted, 'the complex, detailed and dynamic nature of regulatory framework raises both substantive and procedural difficulties for any third country intended on full or partial alignment with the *acquis*.' Restructuring the energy sector is a particularly demanding process requiring an overhaul of the whole regulatory framework, de-monopolization, and fundamental reorganization of how the infrastructure is managed. While various kinds of reform measures have been taken since 2014, it is evident that so far the authorities lack an overarching and coherent vision for the reform of the gas market.

## Conclusions

The EU and Russia have been pursuing opposite objectives in Ukraine and have used different instruments to achieve them. In legal terms, Ukraine–Russia energy relations lacked a stable and functioning legal framework resulting in negotiations conducted on an ad hoc basis in a highly politicized, non-transparent way. This approach worked to Russia's advantage in particular by providing tailored (dis)incentives for the Ukrainian elites. With the gas trade generating massive opportunities to the ruling elites in Ukraine to seek personal enrichment, Russia could simply rely on the vested interests inside Ukraine to preserve Ukraine's monopolized, inefficient, and opaque gas sector in its unreformed state (Razumkov Centre 2012, 35). This is very much in line with Hirschman's conceptual framework, as the difficulty for Ukraine of dispensing with energy dependence with Russia was aggravated by 'the strength of the vested interests which A has created by its trade economics of B' (1980, 18).

Hirschman (1980) argues that economic asymmetry confers power on the dominant partner, which can influence developments in the smaller state. Certainly, this was true in Russia's policy toward Ukraine until 2014. Up until that point, Russia was able to use its economic muscle to threaten Ukraine by stopping gas supplies, 'because an interruption of the relationship would cause much greater distress in B than in A' (Abdelal and Kirshner 1999, 120). Ukraine's salvation lay in its position as a transit country, meaning that Russia could only use this strategy intermittently, and even then only for very short spells. Nevertheless, being a smaller country, Ukraine carried the bulk of the risks and costs of the deterioration in relations, especially with Russia investing in alternative transit routes. Yet paradoxically, despite Russia's superior power in the relationship, the ineffectiveness of Moscow's policy of offering subsidized gas to neighboring states to shape their domestic and foreign policies would suggest that this was not a viable long-term option (Closson 2011; Drezner 1999). Russia was unable to secure the concessions it sought; indeed, its actions have had the opposite effect.

Therefore, asymmetric interdependence by itself cannot explain bargaining outcomes between more powerful and weaker states (Keohane and Nye 2000, 21). After two decades of failing to achieve its strategic objectives vis-à-vis Ukraine, Russia's shifted to coercion against Ukraine in 2014 to achieve them (Dragneva and Wolczuk 2015). As Keohane and Nye (2000, 24) argue 'employing force on one issue against an independent state with which one has a variety of relationships is likely to rupture mutually profitable relations on other issues.' Against the backdrop of military aggression, Ukraine has been prepared to incur whatever costs were necessary – even curtailing its trade and energy relationship with Russia – in order to preserve its sovereignty. In other words, the use of force disrupted complex and longstanding patterns of interdependence. In broader terms, the analysis of Ukraine–Russia energy relations clearly indicates that economic interdependence per se does not create 'a new brave world of cooperation' that replaces 'the bad old world of international conflict' (Keohane and Nye 2000, 9).

In comparison to Russia, for a long time the EU was much less effective in shaping domestic developments in Ukraine. The EU's late arrival on the scene and overall endeavors to influence Ukraine by exporting a 'regulatory state' model in a depoliticized, rule-oriented, technocratic approach account for EU's limited influence. The scale of rents that elites were able to extract from the energy sector dwarfed the amount of financial support offered by the EU. And yet the EU expected the Ukrainian elites to do what was good for the country and dismantle the system that had been benefiting the same elites, thereby ignoring the political economy of post-Soviet Ukraine (Dragneva

and Wolczuk 2012a). Ukrainian elites were formally open to the flow of rules as evidenced by a number of agreements between the EU and Ukraine. But, in practice, the pre-existing deep-seated interests of Ukrainian elites perpetuated the opaque gas trading system, resulting in them being very selective about the rules that they were prepared to adopt.

Since 2014, Russia's coercive actions deepened Ukraine's asymmetric interdependence with the EU, which in turn made its support conditional on domestic reforms, including in the energy sector. However, this turn westward does not mean that there will be rapid and smooth alignment with EU rules. Only gradual reforms of the gas market have been embarked upon (as already evidenced by the slow adoption and implementation of the new law on the gas market in 2015). Even for neighboring countries most oriented toward the EU, energy is a particularly challenging sector for the transfer of EU rules. EU policy is supply-driven and hence rather ill-suited to the conditions of countries, such as Ukraine. Still, following the footsteps of the three Baltic states, Ukraine is set on limiting its interdependence with Russia and, thereby, ending its corrosive impact on domestic developments. Reforming the energy sector will be a long-term challenge and thus it remains to be seen whether Ukraine will be the first country in the 'common neighborhood' to break the vicious circle of energy dependence, inefficiency and corruption.

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### Notes

1. The EU rules, which promote energy efficiency, investment in renewable sources of energy, and the creation of the energy market, curb power of energy monopolies. A competitive energy sector attracts investment and promotes diversification of contracts and supplies.
2. I am grateful for Margarita Balmaceda for making this point.
3. The *acquis communautaire* is the body of law and obligations of EU accumulated since 1958 to the present day. It comprises all the EU's treaties and laws (directives, regulations, decisions), declarations and resolutions, international agreements, and the judgments of the Court of Justice as well as action that EU member states take together in areas such as the Common Foreign and Security Policy (CFSP).
4. Also, the feasibility study and environmental and social impact assessments of the modernization of the Ukrainian GTS system and underground storage were funded by the EU in the framework of the Neighborhood Investment Facility to prepare the ground for investments by international financial institutions in the GTS.
5. The Energy Community was set up to promote compliance with the EU's complex and detailed regulatory templates for the creation of energy markets in non-member states. The Energy Community is an international organization containing the EU (represented by the European Commission) and several Balkans countries (and eastern neighbors). As of June 2015, the members included Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia, Kosovo, Moldova, Montenegro, Serbia, and Ukraine. Norway, Turkey, and Armenia have observer status in the organization, whereas Georgia has applied to join. The Energy Community aims to extend the EU's internal energy market to southeastern Europe) and the Black Sea region. Its activities, which related to gas, electricity, security of supply,

renewable energy, oil, energy efficiency, environment, and competition, are mainly financed by the EU budget. The Energy Community Treaty was signed in 2006 for the initial period of 10 years, after which it can be extended by the consent of the participating parties. Ukraine signed the Protocol concerning accession to the Energy Community in September 2010 and became its full-fledged member in February 2011.

6. With regard to the energy sector, membership in the Energy Community is the most important commitment to align with EU rules. The coveted Association Agreement merely re-asserts the obligations related to the membership (Title V, Chapter 1, on 'Energy Cooperation, including Nuclear Issues').
7. The example of Moldova was instructive: Gazprom gained 50 percent ownership of the Moldovan transit pipelines and then Russia demanded the suspension of Moldova's Third Energy package commitments as an explicit condition for lowering gas prices. In 2012, Moldova succumbed to Russian demands for the derogation of its commitments within the Energy Community till 2020.
8. Secretary General of the Energy Community, Janez Kopac at [https://www.energy-community.org/portal/page/portal/ENC\\_HOME/NEWS/News\\_Details?p\\_new\\_id=7101](https://www.energy-community.org/portal/page/portal/ENC_HOME/NEWS/News_Details?p_new_id=7101)

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